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SUBJECT: SCENESETTER FOR THE VISIT OF DEPUTY SECRETARY
STEINBERG AND SENIOR DIRECTOR LIPTON

Summary

¶1. (SBU) Your April 26-28 visit to Kyiv comes in the midst of Ukraine's unfolding economic and financial crisis. The IMF has recently concluded its mission review, recommending disbursement of a second loan tranche that had been delayed for two months. The agreement with the IMF is a major accomplishment for Ukraine's authorities, the Prime Minister in particular, who managed to pass legislation and issue resolutions to cut the fiscal deficit. Nevertheless, there remains significant work on bank recapitalization and resolution, each necessary to prevent a deeper than nine percent GDP economic downturn that is now foreseen by the World Bank.

¶2. (SBU) Complicating resolution of economic issues, political relations between the president and prime minister have remained dysfunctional. Some effort has been made recently to appear more coordinated - the March 23 gas conference hosted by the European Commission seems to have ushered in a new era of trying to keep up appearances, and the mood seems to have been extended by the need to meet IMF conditionalities on delivery of further tranches. Nevertheless, the political situation remains the driver of daily Ukrainian policy making, as the leading political blocks and their leaders jockey for position in upcoming presidential elections. Further complicating the political situation, the Prime Minister and leader of the opposition are negotiating to form a new, broad coalition that would push through major constitutional changes.

¶3. (SBU) Ukraine's relationship with Russia has remained tense and complicated. Since the August 2008 Georgia-Russia conflict, Ukrainian perceptions of the potential security threat presented by Russia have come into greater focus, particularly against the backdrop of continuing opposition by some NATO members to MAP status for Ukraine. Changing U.S. policy toward Moscow has led to speculation that the U.S. has softened its support of Ukraine as the price of improving U.S.-Russia relations. End Summary.

Major Themes

¶4. (SBU) We see the opportunity with your visit to convey the following themes to Ukrainian interlocutors:

- Economic: The agreement with the IMF is a major accomplishment, but you cannot rest on these laurels. In particular, a great deal of work remains to be done to get the banking sector out of the deep hole you are still in.
- Political: The political squabble between the President and Prime Minister was affordable when the economy was growing at seven percent annually. It is totally unaffordable when facing a severe economic decline. Yes, your constitution needs to be amended. But the international

community can only support you if the amendment process follows your constitution, is democratic, and is broadly accepted by Ukrainians.

- Political/Security: The Obama Administration strongly supports Ukraine. Our desire to reinvigorate our relationship with Russia does not require a change in our orientation toward Ukraine. We reject zero-sum arguments that we can pursue positive relations with one, but not both. Decisions regarding the pursuit of membership in NATO are up to Ukraine. The U.S. has supported and will support your decision. NATO's door remains open to Ukraine, but NATO does not drag countries into the Alliance against their own will.
- Energy/EU: You need to follow through on reforms agreed on with the EU on March 23 in the energy sector.

IMF Relations and Economic Challenges

15. (SBU) The IMF mission team recently concluded its review of Ukraine's progress under the Fund's October 2008 Stand-By Arrangement. Disbursement of the IMF's second loan tranche had been delayed since mid-February, due to an unfinanced budget deficit of roughly 5 percent of GDP (roughly \$6.25 billion) and a lack of progress on bank recapitalization. In recent weeks, the Rada has taken measures to raise excise taxes on tobacco and alcohol, but when it failed to pass legislation on April 14 that would have made modest cuts to pensions and reduced Natchaz's budget deficit, the Cabinet of Ministers stepped in with 19 resolutions that aim to provide

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the fiscal discipline called for by the IMF. The action was clearly prepared long before the Rada vote, and appears to have had the full support of the IMF, which has indicated that it will accept the resolutions in lieu of laws. The IMF looks set to disburse its second tranche after the Fund's board meets in mid-May, and it has indicated it would increase the tranche from \$1.87 to \$2.8 billion, with \$1.4 billion devoted to the budget gap.

16. (SBU) The IMF's decision to provide budget support -- taken together with Rada-backed excise taxes, CabMin resolutions, and expected funds from a \$500 million World Bank DPL loan -- do not fully cover Ukraine's expected 2009 budget deficit. With the blessing of the IMF and the World Bank, Ukraine continues to request budget support from the United States, the European Union and other key states, Russia, Japan, China, and Saudi Arabia. Thus far, no bilateral budget support has been forthcoming. Deputy Prime Minister Hryhoriy Nemyria is expected to actively follow-up on this request during his trip to the United States for the IMF and World Bank spring meetings on April 22-27. Immediately following your visit to Ukraine, Prime Minister Yulia Tymoshenko will travel to Moscow to call for Russian bilateral budget assistance. She is also expected to raise the matter with German Chancellor Angela Merkel on April 30, when the two reportedly will meet in Warsaw on the margins of European People's Party Congress.

17. (SBU) As analysts project that Ukraine's GDP will decline at least 9 percent in 2009, stresses on the banking sector have mounted, causing the IMF and World Bank to call for urgent reforms. A bank recapitalization unit has been recently established in the Ministry of Finance, and initial plans have been made for a problem bank unit at the NBU to oversee bank resolution. Although only a nascent regulatory framework has been developed for either, the GOU has proposed seven domestic banks to receive initial recapitalization funds by May 1. The GOU will likely move to write down existing shareholders with current regulatory power, but the basis to do so is weak and could be challenged in court. The GOU plans to effectively nationalize the banks it recapitalizes by taking majority stakes. Foreign bankers

have told us that they expect shareholders of parent banks in Europe, Russia, and the United States to fully finance their recapitalization costs. Despite concerns of deleveraging, we have not heard that any foreign-owned banks are seriously contemplating pulling up stakes.

Renewed Orange Coalition Falters Again

¶18. (SBU) Orange Revolution allies Viktor Yushchenko and Yuliya Tymoshenko united forces following an unexpectedly strong showing by Tymoshenko's political bloc (BYuT) in the September 2007 pre-term parliamentary elections. They formed a coalition and established a government in late 2007 with Tymoshenko as Prime Minister. Many hoped that they would work together better than they had in 2005, when Yushchenko dismissed Tymoshenko after seven months of infighting. In early September 2008, following a string of mutual recriminations, Yushchenko's Our Ukraine-People's Self Defense bloc (OU-PSD) pulled out of its coalition with Tymoshenko's parliamentary faction.

¶19. (SBU) The split between Yushchenko and Tymoshenko was finalized on October 8, when the President dissolved the Rada and called pre-term elections. PM Tymoshenko opposed the decision to call pre-term elections, citing the unfolding domestic economic crisis as requiring political continuity and stability. Tymoshenko successfully delayed preparations for early elections, which required the passage of laws in parliament both on administering and funding the vote, while cobbling together a new coalition. The new coalition announced on December 9, thereby avoiding early elections, is comprised of the PM's bloc, Rada speaker Volodymyr Lytvyn's bloc and a majority of the now fractured former pro-presidential OU-PSD bloc. The new coalition, on paper a majority of MPs, has struggled to pass legislation in the Rada and has often had to turn to the non-coalition Communists to successfully push forward its agenda.

Moving Toward Elections - and a new constitution?

¶10. (SBU) In the latest salvo in the ongoing feud between Tymoshenko and Yushchenko, the PM's coalition joined with the opposition Party of Regions and the Communists to set October 25 as the date for the next presidential election, rather than a date in December or January as expected. Yushchenko

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has challenged the Rada's decision in the Constitutional Court, calling the Rada's legal justification for October 25 deeply flawed. However, the President has said that he would agree to the earlier date if simultaneous early Rada elections were also held. There is no obvious legal justification for pre-term parliamentary elections. Tymoshenko and the coalition are against simultaneous elections. BYuT and Regions are attempting to negotiate an entirely new coalition that would seek broad Constitutional changes in the near term that would have the president elected in the parliament, and establish a full parliamentary republic.

¶11. (SBU) Tymoshenko, Yushchenko, and opposition head and former PM Yanukovych are all likely candidates for the presidential election. Recent polls show that Tymoshenko and Yanukovych are the likely contenders in a presidential runoff. Arseniy Yatsenyuk, the young liberal former Rada speaker and foreign minister, is considered a credible challenger to Yanukovych and Tymoshenko, and has announced that he intends to run for president. Yushchenko, whose popularity polls in the low single digits, is not expected to be a serious contender and some observers speculate that he may not even run. Polls also show that voters are disillusioned with the political process, which could lead to low voter turnout, or an increase in protest voters.

Ukraine's Security Concerns

¶12. (SBU) Ukrainian perceptions of potential security threats have sharpened since the August 2008 Georgia-Russia conflict.

These sensitivities are set against doubts about whether NATO will ever allow Ukraine Membership Action Plan (MAP) status. For the most part Ukrainian officials remain committed to pursuing Euro-Atlantic integration. How long they will continue to do so in the face of the continuing lack of Ukrainian public support (at only about 25%) for NATO membership is not clear. Many of our interlocutors have questioned whether "the reset button" signals a departure from our policy of strong support for Ukraine's western orientation, including its Euro-Atlantic integration.

¶13. (SBU) The August conflict and Russian occupation of Georgian territory, and Russia's subsequent recognition of Georgia's breakaway regions, has raised specific worries about Russian intentions toward Crimea, and whether Russia intends to pursue a "South Ossetia strategy" in this autonomous Ukrainian region. A lack of progress in regular negotiations regarding the Black Sea Fleet has exacerbated these suspicions. Rumors continue to circulate that Russia is issuing passports in Crimea; however, facts do not seem to bear this out. President Yushchenko has taken a strong position rejecting Russian actions in Georgia. Ukraine will not recognize the independence of either breakaway region. Ukraine does not intend to change its policy allowing arms sales to Georgia, and intends also to continue Ukrainian participation in the UN Observer Mission in Georgia (UNOMIG). Despite the officially strong solidarity with Georgia from Yushchenko, officials occasionally lament that Saakashvili's actions in August have caused discord in Ukraine-Russia relations.

¶14. (SBU) The non-extension of the Strategic Arms Reduction Treaty (to which Ukraine is a party) has become a concern in the context of aggressive Russian rhetoric. Speaker Lytvyn and MFA officials have raised with us the need for a new security guarantee for Ukraine. To this end, Prime Minister Tymoshenko called for greater Ukrainian participation in the European Security and Defense Policy (ESDP) at this year's security conference in Munich. Russian foot-dragging on border demarcation and Russian unwillingness to engage in a meaningful way through normal bilateral commissions or working groups have also served to increase the level of general concern in the GoU regarding the extent of Ukraine's strategic exposure. Ukrainian officials view Russia's parallel "one plus two" process on Transnistria settlement discussions as detrimental to the internationalized 5 2 process, and also to Ukraine's interests.

¶15. (SBU) Some prominent political figures seem already to have decided that the prudent course lies closer to Moscow in today's strategic environment. For example, Rada Speaker Lytvyn, who has in the past favored neutrality over NATO membership, recently asserted that the answer to Ukraine's problems of funding and building a reliable navy is to request that the Russian Black Sea Fleet protect Ukrainian naval interests.

¶16. (SBU) Prime Minister Tymoshenko has maintained an

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understated approach on NATO membership, and has focused her public commentary instead on increasing Ukraine's ties to the EU, including her statement at the Munich Security Conference.

Energy

¶17. (SBU) In January 2009, PM Tymoshenko and Russian PM Putin signed controversial supply and transit contracts ending the

crisis that saw gas shutoffs to EU Member States, and taking, in some ways, a step toward transparency. The contracts remove controversial gas intermediary RosUkrEnergo (co-owned by Russian's Gazprom and Ukrainian oligarch Dymtro Firtash), and established a fixed formula for determining the price of imported gas. However, the transit price charged to Russia remains below market levels, and, while Ukraine is subject to take or pay provisions in the supply contract, Russia is not subject to similar provisions in the transit contract. The price for Russian gas sold to Ukraine will be \$270 per thousand cubic meters (tcm) beginning in second quarter 2009.

Prime Minister Tymoshenko will travel to Moscow for talks with Putin on April 29 at which she is expected to offer to negotiate an intergovernmental agreement with Moscow to govern the Russia-Ukraine gas relationship.

¶18. (SBU) Ukraine continues to have severe domestic problems in its energy sector, which both undercut state oil and gas company Naftohaz's financial viability and prevent development of domestic oil and gas resources. Domestic natural gas prices for the general population and municipal heating companies are well under the import price. State budget subsidies to Naftohaz aim to bridge the gap between the import price and the domestic consumer price, but many domestic consumers still fail to pay on time and in full. Ukraine's complicated legal procedures for exploration and development of oil and gas deposits dissuade foreign investment into the sector.

¶19. (SBU) The March 23 Brussels conference aimed to bring PM Tymoshenko and President Yushchenko together to commit to reforms that would bring Ukraine's gas sector in line with the EU energy community treaty. Based on the Ukrainian commitment to these reforms, the World Bank, the European Bank for Reconstruction and Development, and the European Investment Bank, pledged they would provide financing for the modernization of Ukraine's gas transit system (GTS). Ukraine is to provide a detailed timetable for sector reforms by the end of 2009 and implement the reforms by 2011, including the phase out of domestic price subsidies.

¶20. (SBU) Ukraine's commitment to reform in the energy sector is yet to be seen. While Tymoshenko and Yushchenko provided a unified voice in Brussels, their cooperation has flagged since returning to Kyiv. Moreover, the steps Ukraine will have to take to implement the reforms required by the EU and the IFIs will be hard for Ukraine to swallow, especially in the midst of its economic crisis.

TAYLOR